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SUBJECT: BULGARIA: NEW GOVERNMENT RESPONDS TO THE ECONOMIC CRISIS

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¶1. (SBU) SUMMARY: Amid a deepening recession, the new government's focus is on promoting recovery, maintaining fiscal discipline, and avoiding an IMF package. Its short-term "Anti-Crisis" plan includes an ambitious set of 82 measures which range from the vague to the concrete, many still requiring implementation. Despite inheriting a sizeable deficit, the government has reined in spending and proposed a nearly-balanced draft 2010 budget. Although Bulgaria is expected to be one of the only EU countries to meet the Maastricht criteria in 2009 and the only one to meet these requirements in 2010, its upcoming application for ERM-2 will likely encounter political resistance from the EU. END SUMMARY.

Macro Picture

¶2. (SBU) Officially in recession since the first quarter of 2009, the Bulgarian economy continues to slide, posting year-on-year declines of 4.9 percent and 5.8 percent in the second and third quarters respectively. The IMF is now forecasting a 6.5 percent drop in GDP for 2009, followed by a further 2.2 percent contraction in 2010. Compared to 2008 levels ($9.7 billion), foreign direct investment (FDI) flows to Bulgaria are expected to drop by at least 50 percent in 2009 ($4.5 billion to date) and then increase marginally in 2010. The IMF and some economists indicate that a weak recovery is possible in the third quarter of 2010. Bulgaria's 8.23 percent unemployment rate is lower than the EU average, but is expected to increase in the next six to nine months.

¶3. (SBU) Although credit remains tight due to relatively high interest rates, the financial system is generally healthy thanks to high reserves and conservative lending policies. As of October 23, international reserves amounted to 23.5 billion leva ($17.8 billion), of which the Bulgarian government's fiscal reserve is 7.1 billion leva ($5.4 billion). According to the Bulgarian Central Bank Governor, commercial banks maintain a 17.6 capital-to-asset ratio, and are thus well-positioned to deal with non-performing loans.

Bulgaria's Anti-Crisis Plan

¶4. (SBU) The Council of Ministers approved a short-term "Anti-Crisis" plan to respond to the recession September 23. The plan includes 82 measures aimed at improving Bulgaria's macro economy, financial system, business climate, agricultural production, infrastructure, employment, social services, and EU funds management. Implementation will be a challenge. For example, many of the so-called measures are vaguely worded such as "ending corruption in the use of EU funds." Some measures will require Parliament to pass implementing legislation (i.e. the budget) while others can be carried out administratively (i.e. creating a

computerized link between customs with tax authorities). Some of the more specific measures include preservation of the lev's peg to the euro until Eurozone entry, cutting government operating costs by 15 percent, decreasing the minimum capital requirement for new businesses to one euro, decreasing employers' social security contributions by two percent, creating a national employment database, and maintaining the 20 percent VAT rate. The Anti-Crisis Plan will be in effect through April 27, 2010, when the IMF is expected to conduct its next staff mission.

Restoring Fiscal Discipline

¶5. (SBU) After taking office in July, the new government inherited what they say was an 11 percent budget deficit from its predecessor due to a pre-election spending spree during a time of declining revenues. Reversing a pre-election promise, the new finance minister (and former World Bank official) Simeon Dyankov decided against requesting an IMF precautionary agreement. Instead, he cut government expenditures and ramped up customs enforcement, steps later applauded by the IMF. As a result, the budget returned to positive territory in October. The government is now projecting a 0.6 percent budget deficit for 2009. An EU report released October 23 ranked Bulgaria in the top five EU countries for long-term sustainability of public finances.

¶6. (SBU) Following the Anti-Crisis Plan's call for a balanced budget, the finance minister proposed a 2010 draft budget which projects a 0.7 percent deficit, or 470 million leva ($349.3 million). The budget which passed its first reading November 17 is based on higher revenues through customs enforcement, EU funds absorption, and higher excise taxes on cigarettes, fuel, and alcohol. Funding priorities include social security, health care, education, and the environment. Bulgaria's defense spending is slated to be cut by 10.3 percent, from 993.0 to 890.6 million leva

($754.7 to $676.9 million), well below the two percent GDP threshold required by NATO.

Eurozone Prospects Improve; Political Hurdles Remain
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¶7. (SBU) The recession's silver lining is lower inflation, declining from almost 15 percent in June 2008 to -0.3 percent in October 2009 (year-on-year). The government is projecting 2.2 percent inflation for 2010. With inflation and deficits under control, Bulgaria is expected to be one of the only EU countries to meet the Maastricht criteria in 2009 and the only one to meet these requirements in ¶2010. Based on its 2010 economic and financial outlook, the government has announced its intention to apply for ERM-2 membership in the spring of 2010. Our contacts are not optimistic about a quick ERM-2 entry, however, because it will require a political consensus among all 27 EU members, some of which still question Bulgaria's resolve to fight organized crime and corruption.

¶8. (SBU) COMMENT: After inheriting a large deficit, the Borissov government's proposed 2010 near-balanced budget is ambitious and commendable. It will also be painful. After years of enviable growth, Bulgarians are not used the belt tightening that is envisioned. The local economy is still vulnerable to external developments, particularly a weak recovery of major EU export markets, which could result in smaller than expected budget revenues. To maintain popular support, the government will need to explain the need for this self-imposed austerity while orientating social programs towards preventing the erosion of income, especially for those households that will become indebted as the crisis continues. There has been no more talk of external help at this point, at least until sometime next year when the Anti-Crisis plan expires and authorities will likely need to revise next year's budget. END COMMENT.

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